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Panama: Stability of Banking Sector

Summary

The massive capital flight from Panama sparked by political unrest in June has slowed to a trickle, substantially reducing the risk of a collapse of the banking sector and a subsequent sharp decline in the overall economy. Although we believe conditions in the banking sector will remain stable over the near term, it will continue to be vulnerable to economic uncertainty and political turmoil. [redacted] 25X1

Discussion

Banking has been a key component of Panama's service economy since 1970, when the enactment of a comprehensive banking law sparked the country's rise as an international financial center. Panama's banking center ranks among the top 20 in the world, with more than 130 licensed institutions and nearly $40 billion in assets, according to academic studies. It contributes roughly 7 percent of Panama's GDP and provides 9,000 local jobs. Moreover, Panama City's access to commercial lending has been enhanced, in our view, by the presence of a large number of international banks, which hold nearly half of Panama's $3.8 billion foreign debt. [redacted] 25X1

The stability of the financial sector appeared at risk when political unrest beginning in June sparked significant capital flight. Early estimates from the US Embassy [redacted] 25X1 put capital flight as high as $4 billion, but [redacted] 25X1 [redacted] a more conservative figure of some $1.5 billion.* 25X1 Whatever the total, withdrawals from the banking system, particularly locally owned banks, have had a severe impact on the economy and on international confidence in Panama:

-- The 12 privately owned Panamanian banks lost roughly two thirds of their liquidity by the end of August, and half reportedly were in danger of closing, [redacted] 25X1 [redacted] The liquidity crisis prompted a 25X1 group of Panamanian bankers to visit the United States in September to ask commercial banks and the US government

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* Precise assessment of financial flows is difficult because of strict secrecy laws and the lack of capital controls--the very factors that fostered the rise of Panama as a world banking center.

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to provide a financial "safety net" for the banking system.

-- Government-owned banks, including the National Bank of Panama--the country's equivalent of a central bank--also experienced a serious decline in deposits that threatened the regime's ability to pay its bills.

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-- The loss of liquidity forced bankers to suspend lending to local businesses, curtailing activity in key sectors of the economy and reducing industrial and agricultural output, according to Embassy reporting. [redacted] 25X1

The situation has stabilized somewhat in the last month as depositors have begun to return some of the funds they had withdrawn and because of recent actions by US banks:

-- [redacted] capital flight from the banking system has almost stopped, with withdrawals exceeding deposits by only a slight margin. 25X1

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-- The liquidity problems of Panamanian banks have been eased because US commercial banks have purchased jointly held loans, according to US Embassy reporting. [redacted] 25X1

As a result of these developments, we believe the risk of a collapse of the banking sector and subsequent sharp decline in the economy--the scenario posited by Panamanian bankers during their talks in the United States--has receded. At least in the short term, the reported slow return of some deposits probably will help to calm the fears of international banks about the viability of Panama as an offshore banking center, and a desire to add new accounts by capturing a portion of these funds may increase their incentive to retain local operations. The National Bank reportedly is planning a major publicity campaign in early October that could stimulate additional inflows and further ease pressure on other Panamanian banks. [redacted] 25X1

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While we believe conditions in the financial sector are likely to remain relatively stable over the near term, it remains vulnerable to economic uncertainty and political turmoil. Lingering concerns about liquidity probably will cause bankers to limit the provision of credit to key sectors of the economy, contributing to negative economic growth that could exceed 3 percent this year, according to the Embassy. Recent press reports indicate, for example, that the construction industry has been particularly hard hit by tightened credit resulting from the banks' financial difficulties. More than 30 construction projects have been suspended--and 25 percent of the industry's labor force laid off--since June. A prolonged recession and higher unemployment could fuel popular unrest and encourage the opposition to renew its challenge to the government. In such an event, nervous depositors probably would withdraw their funds, and international banks would again consider terminating their local operations. [redacted] 25X1